especially the 'watchdog' function performed by the independent directors, has served investors well at minimal cost."[3]

Nevertheless, the system of director oversight, like any other, must periodically be reexamined to ensure its continuing effectiveness. Reexamination is especially appropriate now, as the investment company industry has grown and changed dramatically in recent years, offering new types of funds, entering new distribution channels, and appealing to new segments of the investing public. These changes have required investment company boards to change as well, developing new areas of expertise, posing new questions to management, and adjusting their practices and procedures to remain effective as board workloads have increased and become more complex.

The responsibilities of fund directors were recently explored in depth at the SEC Roundtable on the Role of Independent Investment Company Directors held on February 23-24, 1999, in Washington, D.C. At the Roundtable, SEC Chairman Arthur Levitt hosted panels of experts from a variety of disciplines to evaluate how independent directors are meeting the challenges posed by the growth and increased complexity of the mutual fund industry and its growing importance to American investors. Significantly, the Roundtable's deliberations did not reveal a need for wholesale restructuring of the system of mutual fund governance and the role of independent fund directors. As Chairman Levitt subsequently noted, however, there was "broad agreement" that the existing "mutual fund governance structure could and should be improved so that the directors are better able to serve shareholders."[4]

---

[3] SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation (May 1992) at 253.

[4] Remarks of SEC Chairman Arthur Levitt at the Mutual Funds and Investment Management Conference, Palm Springs, CA (March 22, 1999) ("Remarks of SEC Chairman Arthur Levitt").

Following the Roundtable, Chairman Levitt announced a "major Commission initiative to improve mutual fund governance," including specific regulatory proposals that the SEC would consider. At the same time, the Chairman called upon the mutual fund industry "to undertake a similar effort in enhancing the role of independent directors."[5]

In response, Matthew P. Fink, President of the Investment Company Institute, announced the formation of an Advisory Group on Best Practices for Fund Directors. The Advisory Group was given the mission to identify the best practices used by investment company boards and to recommend those practices that should be considered for adoption by all fund boards. The membership of the Advisory Group consists of three experienced independent fund directors and three senior executives of major fund management organizations who serve as affiliated directors of the funds managed by their organizations.[6]

In addition to drawing upon the experience of its members, the Advisory Group sought the views of other independent directors of investment companies, fund management representatives, former senior SEC officials, representatives of accounting and law firms with expertise in investment company matters, academicians knowledgeable in the fields of investment company regulation and corporate governance, representatives of consumer and investor organizations, and other individuals with expertise in investment company, fund director and corporate governance matters.[7]

In developing this Report and the recommendations herein, the Advisory Group sought to identify those practices that act to maintain and enhance a culture of independence and

---

5 Id.

6 See Appendix A for the biographies of the members of the Advisory Group.

7 See Appendix B for a list of the persons with whom the Advisory Group consulted.

effectiveness on the part of fund boards. The Advisory Group concluded that such practices would help ensure that fund directors can effectively represent the interests of fund shareholders. In varying degrees, these practices, which go beyond statutory and regulatory requirements, have already been adopted by many investment company boards and tested by actual experience. Adoption of the recommended practices by other fund boards would bolster the effectiveness of the current system in safeguarding the interests of fund shareholders, particularly in guarding against potential conflicts of interest between the fund and the fund's investment adviser.

The Advisory Group determined to focus its recommendations on practices that enhance the structure and operations of fund boards, rather than seek to develop guidelines that would govern how fund boards should address specific issues (e.g., brokerage allocation or portfolio valuation). The latter issues are apt to involve different considerations for different fund boards, and the Advisory Group did not believe it was necessary or appropriate to attempt to guide the exercise of directors' judgments in these areas. Instead, the Advisory Group concluded that the adoption of practices that enhance the overall independence and effectiveness of fund boards will help assure that individual issues are addressed and resolved in a manner consistent with the best interests of America's more than 70 million mutual fund investors.

II. THE ROLE OF FUND DIRECTORS

Meaningful recommendations to enhance the independence and effectiveness of fund directors require an understanding of the unique role these directors play. Like other corporate directors, directors of investment companies must discharge fiduciary duties defined by state law.[8]

---

[8] Most funds are established in corporate form under Maryland or Delaware law or in business trust form under Massachusetts or Delaware law. (With a few exceptions, the Act does not distinguish between the directors of a corporation and the trustees of a business trust. In this paper, the term "director" is used to include both.) State law requires that directors adhere to the fiduciary duties of loyalty and care in carrying out their responsibilities. The duty of loyalty (continued)

These duties apply to all fund directors – both independent directors and affiliated directors. Unlike other corporate boards, however, investment company boards are subject to structural requirements and to specific obligations imposed by the Act and SEC regulations to oversee fund operations and, in the case of independent directors serving on fund boards, to protect against conflicts of interest between funds and their service providers. The most important of these requirements and obligations are discussed below.

Federal law mandates that investment company boards include at least a specified percentage of independent directors. Section 10(a) of the Act generally requires that at least forty percent of the directors of an investment company not be "interested persons" (as defined in the Act) of such company, its investment adviser or principal underwriter. In the case of open-end funds offering shares through an affiliate of the adviser, which is quite common, the Act effectively requires a majority of the fund board to be independent of the adviser/underwriter. [9] The vast majority of fund boards today consist of a majority of independent directors.

---

generally mandates that directors perform their duties in good faith and in a manner reasonably believed to be in the company's best interests. Fundamental to the duty of loyalty is the avoidance of self-dealing. The duty of care generally obligates directors to perform their functions with the degree of care that an ordinarily prudent person in a like position would exercise under similar circumstances.

[9] See Section 10(b) of the Act. In addition, Section 10(c) of the Act requires bank-sponsored funds to have a majority of independent directors. Moreover, Section 32 of the Glass-Steagall Act generally provides that there may be no overlap between officers and directors of an open-end fund and officers and directors of a member bank of the Federal Reserve System (which includes all national banks and most large state-chartered banks). As a result, most, if not all, of the directors of open-end funds sponsored by a bank or a bank affiliate are not employed by the banking institution or its affiliate. Funds whose sponsors are undergoing a change of control, and who are relying on the safe harbor in Section 15(f) of the Act, are required to have a board that is composed of directors at least 75% of whom are not "interested persons" of the selling or purchasing adviser for a period of three years after the reorganization.

The Act imposes strict standards for measuring the independence of investment company directors. For example, the Act excludes from independent director status any person affiliated with the investment adviser, principal underwriter or the investment company (except, of course, as a director of the investment company), as well as any person in a control relationship with any such affiliate.[10] The term "affiliated person" is broadly defined to include any officer, employee or 5% shareholder of the investment company, its investment adviser or principal underwriter.[11] In addition, any person affiliated with a brokerage firm is not considered independent.[12] Finally, the Act empowers the SEC, by order, to exclude from independent status any director who has, or within the prior two years has had, a material business or professional relationship with the fund, its investment adviser or principal underwriter.[13] In fact, it is common industry practice to ensure that no director who appears to have, or have had, such a business or professional relationship is counted as an independent director, even in the absence of an SEC order.[14]

Investment company directors also differ from directors of operating companies because they are assigned a series of specific responsibilities under the Act and various SEC rules, orders and interpretations. These include, for example, annual approval of the fund's investment advisory contract, annual approval of the contract with the fund's principal underwriter, valuation

---

10 See Section 2(a)(19) of the Act (defining "interested person") in Appendix C.

11 See Section 2(a)(3) of the Act (defining "affiliated person"). Any member of an affiliated person's immediate family, as well as legal counsel for the investment company, its adviser or underwriter is likewise an "interested person."

12 The SEC has made an exception by rule for brokers who do not transact any business with the fund. See Rule 2a19-1 under the Act.

13 See Section 2(a)(19)(A)(vi) and (B)(vi) of the Act in Appendix C.

14 Nevertheless, the Advisory Group strongly believes that the standard in the Act, which establishes a "bright line" test for ascertaining whether a person qualifies as an independent director, is the correct one for statutory and regulatory purposes.

of certain securities held by the fund, and approval of any distribution plan under Rule 12b-1.[15] Several matters require the approval of both a majority of the whole board and a majority of the independent directors voting separately, because of potential conflicts inherent in the position of the affiliated directors.

Approval of the fund's contract with its investment adviser, including the advisory fee, is one of the more important responsibilities of fund directors. The Act provides that an advisory contract can run initially for a term of no more than two years, and continue in effect thereafter only if the board annually approves it. The standards guiding this process are complex. In cases challenging the fairness of advisory fees, courts have viewed the Act as assigning to the independent directors the primary responsibility for considering those fees. In these cases, courts consistently have found that the independent directors discharged this responsibility diligently and in good faith, and accordingly have not second-guessed their judgment.[16]

Independent directors are not required to engage in a competitive bidding process or to award the advisory contract to the adviser offering the lowest rates. As a practical matter, they must take account of the fact that the fund's shareholders have chosen the adviser in the context of the disclosures in the fund's prospectus and other documents that set forth the material facts concerning the adviser, the fund's investment objectives, strategy and risks, and the management

---

[15] A list of responsibilities imposed on fund directors by the Act and the regulations thereunder is set forth in Appendix D. This list necessarily must be considered in light of each fund's specific activities, and is not intended to serve as a checklist of board responsibilities.

[16] See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983); Krinsk v. Fund Asset Management, Inc., 715 F. Supp. 472 (S.D.N.Y. 1988), aff'd, 875 F.2d 404 (2d Cir.), cert. denied, 110 S. Ct. 281 (1989). Similarly, in some cases, the informed approval of the advisory contract by independent directors has been a substantial factor in the court's rejection of charges that the investment adviser committed a breach of fiduciary duty involving misconduct in violation of Section 36(a) of the Act. See Tannenbaum v. Zeller, 552 F.2d at 427.

fee structure and other expenses of investing in the fund. As one of the Act's draftsmen, Alfred Jaretzki, noted in 1964, "[T]he board of directors does not act in a vacuum . . . [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take action to change it except in unusual circumstances."[17] Consequently, while it is uncommon for fund boards to terminate the investment adviser, the Advisory Group does not agree with those critics who have suggested that this represents a failing on the part of fund directors or, more generally, the mutual fund corporate governance system.

Nonetheless, within this framework, directors have a responsibility under the Act to make certain that management fees are reasonable in light of all relevant facts and circumstances. In this regard, directors consider, among other things, the impact of any economies of scale that may result as the fund grows. SEC Chairman Levitt succinctly summed up the duty of directors with respect to management fees as follows: "Directors don't have to guarantee that a fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band."[18]

Approval of advisory contracts, however, is just one of the responsibilities of fund directors. As noted above, fund directors must monitor and protect against conflicts of interest. While the Act contains broad prohibitions against various types of self-dealing transactions,[19] funds can be faced with other, perhaps more subtle, conflicts. These potential conflicts may

---

[17] Jaretzki, Jr., Alfred, "Duties and Responsibilities of Directors of Mutual Funds," 29 Law and Contemporary Problems 777, 786 (1964).

[18] Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

[19] See Section 17 of the Act which, among other things, prohibits, in the absence of an SEC exemption, purchases and sales of securities between a registered investment company and any of its affiliated persons, as well as joint transactions involving the investment company and an affiliated person.

involve such diverse matters as the allocation of brokerage commissions, the use of fund assets for distribution, the allocation of expenses between a fund and its adviser and among funds, responsibility for any pricing errors or violations of investment restrictions, and personal investing by officers and employees of the fund's adviser. In these and many other areas, independent oversight of fund operations by fund directors helps to ensure that funds will be operated in the best interests of shareholders.

The independent fund directors' job becomes most difficult on those rare occasions when they suspect that the manager may have engaged in illegal or improper conduct. In those instances, directors require the active involvement of the SEC. SEC Chairman Levitt recently acknowledged this need, stating, "Some [have] made the point that the Commission, in allocating key governance responsibilities to independent directors, needs to be actively involved and pursue charges of illegal conduct by fund managers whenever they occur. I couldn't agree more."[20]

Ultimately, the Advisory Group believes that the fundamental responsibility of fund directors is to ensure that the fund's shareholders receive the benefits and services to which they are fairly entitled, both as a matter of law (e.g., resulting from the investment adviser's fiduciary duties to the fund and specific requirements under the Act) and in accordance with investor expectations reasonably created by the fund's prospectus and other disclosure documents. Within this context, it is the responsibility of the fund's board to evaluate the performance of the fund's investment adviser and that of its other service providers on the basis of what is best for shareholders and to apply that same standard in evaluating any proposals for change in fund operations or expenses. On those occasions where the interests of the adviser and fund shareholders diverge, the fund's directors and, in particular, the independent directors, must

---

[20] Remarks of SEC Chairman Arthur Levitt, supra note 4.

effectively represent the interests of the fund and its shareholders. The Advisory Group has drafted the recommendations in this Report with the foregoing in mind.

III. RECOMMENDATIONS

The Advisory Group considered a variety of practices, beyond those required by law or regulation, that are used by many independent investment company directors to help ensure their independence from the fund's investment adviser and other service providers and by both independent and affiliated investment company directors to enhance their effectiveness in carrying out their oversight responsibilities. Set forth below are those practices that the Advisory Group has decided to recommend for consideration by all investment company boards of directors.

The Advisory Group recognizes that every recommendation may not be suitable for every board. Depending on individual circumstances, other practices may be equally or more effective in achieving the objectives of the recommendations.

1. SUPER-MAJORITY OF INDEPENDENT DIRECTORS

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

The Advisory Group recommends that independent directors constitute at least two-thirds of the directors of every investment company board.[21] This will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment adviser or other service providers. The Act requires that

---

[21] Except where indicated otherwise, as used in this section of the paper, the term "independent director" refers to a director that meets the standards contemplated herein (see, e.g., Recommendation 2 below), as opposed to a director that qualifies as an independent director under the Act.

certain important decisions, including those with a clear potential for conflict of interest between the fund and its investment adviser or other service providers, be made by the independent directors voting separately.[22] Nevertheless, a multitude of other issues that require separate consideration of the interests of fund shareholders from those of the adviser may arise in the course of fund operations. The Act does not require a separate vote of independent directors on these matters, nor could it, since they cannot all be foreseen.

The Advisory Group believes that a two-thirds standard will be more effective than a simple majority in enhancing the authority of the independent directors. The Advisory Group notes that while investment company boards meeting this standard are not uncommon, they are far from universal. In order to comply with a two-thirds standard, many fund boards will have to either remove affiliated directors, or add independent directors. Such actions are not without cost. Nonetheless, the Advisory Group believes that the benefits of a two-thirds standard justify recommending it as an industry best practice.

Suggestions have been made that fund boards should be composed exclusively of independent directors. While the Advisory Group recognizes that some funds may find a board consisting of only independent directors to be most suitable under their particular circumstances, as a general matter, the Advisory Group believes that fund boards can benefit from having affiliated directors on the board. Board membership by representatives of the adviser allows for

---

[22] For example, a majority of the independent directors voting separately must approve the fund's investment advisory and underwriting agreements, and any plan to use fund assets to support share distribution under Rule 12b-1, as well as the purchase of joint liability insurance and the selection of the independent auditors. The SEC, by rule, also has relied on the independent directors to oversee a number of other areas where conflicts may arise. See, e.g., Rule 10f-3, regarding purchases of underwritten securities by a fund during the existence of the underwriting syndicate of which an affiliate is a member; Rule 17a-7, governing cross-trades with affiliates; Rule 17a-8, covering mergers of affiliated investment companies; and Rule 17e-1, governing portfolio brokerage transactions through affiliated brokers.

more direct accountability on the adviser's part and a better exchange of information with the adviser. In addition, representatives of the adviser may have greater expertise in many aspects of the operations of the fund. Thus, their participation may enhance the board's effectiveness. Finally, as noted above, affiliated directors are subject to the same fiduciary standards as independent directors.

2. PERSONS FORMERLY AFFILIATED WITH THE ADVISER, PRINCIPAL UNDERWRITER AND CERTAIN AFFILIATES

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

Former officers and directors of the fund's investment adviser or principal underwriter often may be highly desirable candidates for board membership because of their extensive knowledge of the industry, the fund complex and the operations of the adviser and/or underwriter. Nevertheless, prior service as an officer or director of the adviser or principal underwriter may affect the director's independence, both in fact and in appearance. In particular, it may call into question whether the former officer or director would be able to effectively "switch hats."

The Advisory Group therefore recommends that former officers or directors of a fund's investment adviser or principal underwriter not serve on that fund's board as independent directors. The Group further recommends that former officers and directors of certain affiliates of the fund's adviser and principal underwriter – in particular, parent companies that own a majority interest, and majority-owned subsidiaries – likewise not serve as independent directors, as the same potential conflicts can arise in these situations. The Group considered applying this standard to former directors and officers of all affiliates of the fund's adviser and underwriter, but decided against doing so in light of the strength of the prohibition and the fact that the prior relationship to

a significant service provider to the fund may be much more remote in those cases Nevertheless, the Advisory Group recommends that the board's nominating committee (or other body charged with nominating independent directors), as part of the selection process, carefully consider any such relationships and their potential effect on a candidate's de facto independence.[23]

The Advisory Group recognizes that its recommendation goes far beyond current law.[24] It is not meant in any way to call into question the character and integrity of current independent directors that do not meet this standard, nor the propriety of any actions taken by the boards on which they serve. The Group believes, however, that this standard should be adopted because it provides more meaningful assurance of directors' independence and enhances the overall credibility of the system of independent directors.

The Advisory Group does not believe that its recommendation need deprive a fund board of the experience of a former officer or director of the adviser, underwriter or their affiliates. A board that would benefit from the knowledge and experience of such a person may choose to retain the individual as an affiliated director. Alternatively, the individual could serve as a member of an "advisory board." Under these approaches, the fund would benefit from the expertise and

---

[23] For similar reasons, the Advisory Group decided not to recommend applying this standard to all former employees of the fund's adviser and underwriter. Such a prohibition could lead to absurd results (e.g., disqualifying an individual who worked for the adviser for a summer while in college) and could be very difficult to administer. The nominating committee, however, should carefully scrutinize the appropriateness of any such individual serving as an independent director. The Advisory Group believes that former employees of the investment adviser or principal underwriter who had significant responsibilities should be treated similarly to former officers and directors.

[24] As noted above, the definition of "interested person" under the Act provides that any person not having a current affiliation with the adviser or principal underwriter, but who had a "material business relationship" with the adviser or the principal underwriter within the last two years, may be deemed "interested" if the SEC issues an order to that effect. See Section 2(a)(19)(A)(vi) and (B)(vi) in Appendix C.

experience stemming from a person's former associations, without that person being counted as an independent director.

The Advisory Group considered an alternative proposal to impose a period of time (e.g., five years) between a board member's serving as an officer or director of the fund's adviser or underwriter and as an independent director, but decided against recommending it. The Advisory Group believes that such a period would not eliminate questions as to the continuing identification of the former officer or director with the adviser or underwriter. Because of this, as well as the importance of maintaining the public's confidence in the independence of outside fund directors, the Advisory Group has concluded that a permanent prohibition is preferable.

3. CONTROL OF THE NOMINATING PROCESS BY INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

In order to enhance the independence of independent directors, the Advisory Group recommends that independent directors be selected and nominated by vote of a majority of the incumbent independent directors. The Advisory Group's recommendation recognizes that the independent directors are uniquely qualified to evaluate whether a present or prospective director is likely to contribute to the continuing independence and effectiveness of the independent directors as a group. Moreover, control of the nominating process by the independent directors helps dispel any notion that the directors are "hand picked" by the adviser and therefore not in a position to function in a true spirit of independence.[25]

---

[25] The initial independent directors of funds in a new fund complex are, by necessity, named by management. These directors are subject to the same fiduciary duties and responsibilities to the funds and their shareholders as are all other fund directors. Moreover, the standards and (continued)

Independent directors' control of the selection and nomination process for independent directors is already commonplace within the fund industry. Funds that adopt distribution plans pursuant to Rule 12b-1 under the Act are required to provide that independent directors select and nominate their own successors; such funds constitute a majority of the industry. Many funds without Rule 12b-1 plans follow this practice as well.

Frequently, fund boards form a nominating, governance or other committee composed exclusively of independent directors to manage the selection and nomination process.[26] Independent directors' control of the nominating process, however, does not preclude input from persons associated with the fund's investment adviser and its affiliates. Many nominating committees give consideration to suggestions from fund management of persons qualified to serve as independent directors, and nominating committees may give fund management an opportunity to meet with a prospective new independent director prior to a final decision by the committee. The Advisory Group believes that the nature and extent of fund management's input into the nomination process is best left to a fund's independent directors to decide, provided that control of the process rests exclusively with the independent directors.

The election of a nominee to the board is accomplished either by a vote of the board or by a shareholder vote.[27] In either case, the affiliated directors may have an opportunity to vote on

---

requirements under the Act relating to independence serve to ensure the de facto independence of the initial directors. Adoption of the best practices set forth in this Report would further enhance that independence.

[26] A sample Nominating and Administration Committee charter is set forth in Appendix E.

[27] Section 16(a) of the Act requires, as a general matter, that investment company directors be elected by shareholders. Section 16(a) further provides, however, that directors may be appointed by the board so long as, following such appointment, at least two-thirds of the board has been elected by shareholders. The articles of incorporation or trust instruments of virtually all investment companies provide for the appointment of directors under such circumstances.

the nominee. Where state corporation or trust law and the fund's charter permit delegation to a subset of the full board, the Advisory Group believes that the board should delegate to the independent directors the authority to elect, or recommend that shareholders elect, the nominee. In other cases, [28] the Advisory Group believes that the affiliated directors should adopt a policy of generally deferring to the choice of the independent directors.

4. COMPENSATING INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

Independent directors of mutual funds, like directors of other types of companies, are compensated by the entities on whose boards they serve. Compensation varies within the industry, because of differences in the complexity and size of funds and fund groups served by a director, the time commitment required for meetings and other duties, the number of meetings, the compensation levels necessary to attract highly qualified members, and other factors.[29]

The Advisory Group believes that the appropriate level of compensation for serving as a director should be set by the independent directors, acting either as a body or through a

---

[28] For example, under Maryland corporate law, the board cannot delegate to a committee the power to recommend to shareholders any action that requires shareholder approval. See Annotated Code of Maryland, "Corporations and Associations," Sec. 2-411(a)(2) (Michie 1993 Replacement Volume). Thus, where a fund organized as a Maryland corporation intends to recommend board candidates for election by shareholders, both the affiliated and independent directors may have to vote on the nominees.

[29] The time commitment can be affected not only by the number and size of the funds served by the director and the number and length of board meetings per year, but also by, among other things, the nature of the funds (e.g., whether retail, institutional, or insurance product; equity, bond or money market; domestic or foreign), the structure of the board (e.g., whether a director serves on board committees or takes on additional responsibilities by acting as a lead director), the frequency of board consideration of changes in fund operations and expenses, and whether these changes constitute "cutting edge" proposals.

committee. Although setting appropriate director compensation is a function that state law generally assigns to the board as a whole, the Advisory Group believes that the affiliated directors generally should defer to the independent directors on this matter.[30] Placing control over compensation in the hands of the independent directors and not with fund management helps to ensure the independence and effectiveness of the board.

5. FUND OWNERSHIP POLICY

The Advisory Group recommends that fund directors invest in funds on whose boards they serve.

The Advisory Group believes that fund directors can better serve the interests of shareholders if they have a personal investment stake in one or more funds that they serve. Share ownership by fund directors helps to align their interests with those of fund shareholders. In particular, directors can learn more about the quality of the shareholder services provided by a fund group if they personally experience those services from a shareholder's perspective. Accordingly, the Advisory Group recommends that investment company boards in each complex adopt a policy requiring fund directors to invest in one or more (though not necessarily all) funds on whose boards they serve. The policy can make exceptions in those cases where the directors only serve on the boards of funds for which they are not eligible investors, such as institutional or private label funds, or where the funds are not suitable investments for the director.[31]

---

[30] As with the nominating process, such deference should not preclude input from fund management.

[31] Fund groups that may want to compensate their directors in shares should note that the Act prohibits the issuance of shares in return for services without an SEC exemptive order. See Section 22(g) of the Act. As an alternative, fund directors might be paid in cash, but leave standing instructions with the fund's administrator to invest certain percentages of their compensation in specified funds.

6. QUALIFIED INDEPENDENT COUNSEL AND OTHER EXPERTS

The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

The Advisory Group believes that it is important for independent directors to have counsel with expertise in the regulation of investment companies who can advise them as to their responsibilities under both state and federal law. Experienced counsel can help to ensure that the directors understand their responsibilities, ask the pertinent questions, and receive the information necessary to carry out those responsibilities.

Counsel to the independent directors must be independent from the adviser and other fund service providers in order to render objective advice on areas of potential conflict between the fund and its service providers. Courts frequently consider whether the directors have used independent counsel in evaluating whether the directors acted independently of the fund manager in fulfilling their responsibilities to fund shareholders.[32] The Advisory Group believes that counsel

---

[32] For example, the court in Gartenberg noted that the independent trustees received advice from counsel independent of the investment adviser in determining to dismiss the shareholders' derivative suit for excessive management fees. 694 F.2d at 927. See also Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), aff'd, 835 F.2d 45 (2d Cir. 1987), cert. denied, 485 U.S. 1034 (1988) (court dismissed a derivative suit against the adviser for breach of fiduciary duty in part because of the independent directors' regular meetings with outside counsel and counsel's detailed advice regarding the independent directors' legal responsibilities).

for the independent directors also may serve as fund counsel because, in virtually every situation except possibly litigation, the interests of the fund and its directors are aligned.[33]

The Advisory Group recognizes that there are situations where it may be most efficient for the counsel for the fund and independent directors also to provide some legal services to the investment adviser or other service provider. The Advisory Group believes that the rendering of such services by counsel for the independent directors is not inconsistent with its recommendation as long as (a) counsel has made clear that, in the event of a conflict with the fund, counsel will represent the fund and its independent directors and (b) the adviser or other service provider waives any objection and understands that any disclosures that it makes to such counsel are not privileged against disclosure to the independent directors. Counsel should disclose to the independent directors the nature and type of services it performs for the investment adviser or other fund service providers and the amount of fees earned from such services so that the independent directors can evaluate whether the nature and volume of work might have the potential to affect counsel's independence.[34]

The Advisory Group believes that, as a general matter, it is advisable for counsel to the independent directors to attend meetings of the board, appropriate committee meetings and separate meetings of the independent directors. The Advisory Group is sensitive to the cost that this can impose. The Group believes, however, that attendance at these meetings can help to

---

[33] Counsel for a new fund often will have been retained by the manager on behalf of the fund. The Advisory Group believes that such retention is not inconsistent with counsel's representation of the independent directors, as long as the independent directors have the power to replace that counsel.

[34] In some situations, legal services are provided to the fund but paid for by the adviser – e.g., preparation of a fund proxy statement to approve a new advisory contract that is necessitated by a merger involving the investment adviser. The Advisory Group believes that this practice is not inconsistent with its recommendation because counsel's obligation remains with the fund.

ensure that counsel is able to meaningfully fulfill its role. Otherwise, counsel likely would be limited to responding to questions raised by the independent directors, and would not be in a position to effectively identify and respond to the legal issues raised by discussions at the various meetings referred to above. At the very least, counsel to the independent directors should attend any meetings where the advisory contract is considered or where there is a matter on the agenda involving an apparent conflict of interest between the fund and the adviser.

Independent directors also should be able to obtain expert advice from independent accountants and other third parties whenever particular problems or initiatives may call for special expertise. Use of independent consultants may be necessary if the directors are to be effective on matters that are beyond their experience and the expertise of their counsel. Consultants also may give the directors a sense of common practices in the industry.

Accordingly, fund bylaws or committee charters should make clear the authority of the independent directors, or a committee of independent directors, to use fund assets to retain experts when they deem it necessary to further shareholder interests. The Advisory Group recognizes that, in considering whether to retain outside consultants in particular instances, directors will need to take matters of cost into account. As with counsel, the independent directors also must satisfy themselves that any experts they consult are sufficiently independent from the fund's investment adviser and other service providers to provide objective advice.

7. ANNUAL QUESTIONNAIRE ON RELATIONSHIPS WITH THE ADVISER AND OTHER SERVICE PROVIDERS

The Advisory Group recommends that independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates.

Assuring the continuing independence of the outside directors is of primary importance to the Act's regulatory scheme and the integrity of the fund corporate governance system. Accordingly, fund boards should regularly review changes in the affiliations of the independent directors to ensure that a director does not assume relationships that might impair his or her independence. To this end, the Advisory Group recommends that independent directors complete on an annual basis a questionnaire that solicits information on business, financial and family relationships with the fund's investment adviser, other service providers and their affiliates, as well as other relationships that could affect their status as independent directors (e.g., affiliations with registered broker-dealers).[35] The questionnaire should be reviewed by the nominating committee of independent directors (if any), a lead independent director and/or counsel, as appropriate. Such questionnaires may be available to the SEC staff during examinations.

---

[35] A recent SEC enforcement action underscored the need for monitoring business and financial relationships between the independent directors of a fund and the fund's investment adviser or its affiliates. In the Matter of Monetta Financial Services, Inc., Investment Advisers Act Release No. 1702 (February 26, 1998) (the SEC alleged a failure to disclose that independent directors of the fund who were also clients of the investment adviser received preferred IPO allocations).

8. ORGANIZATION AND OPERATION OF THE AUDIT COMMITTEE[36]

The Advisory Group recommends (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

Independent auditors play a key role in assuring the integrity of mutual fund operations. They audit a fund's financial statements annually; as a part of that audit, among other things, they verify security ownership positions, test portfolio valuations as of the end of the fiscal year, and confirm that the fund is entitled to pass-through treatment under the federal income tax laws. They also evaluate the internal control environment of the management company and satisfy themselves as to the integrity of operations at the fund's custodian and transfer agent.

Like many other business organizations, the boards of many funds have Audit Committees that recommend the selection of auditors, review the financial statements and results of the audit, and oversee the fund's internal control system. The Advisory Group recommends that all investment company boards have Audit Committees and that such committees be composed

---

[36] In preparing this section of its report, the Advisory Group considered, among other things, the recent report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. That Committee was established in 1998 by the New York Stock Exchange and the National Association of Securities Dealers, Inc. in response to a call by SEC Chairman Arthur Levitt for improved board oversight of the financial reporting process of public companies. Several of the Committee's most important recommendations – for example, specifying that the auditors are accountable to the board – have long been applicable to investment companies under the Act.

entirely of independent directors. This arrangement is entirely consistent with the Act, which places the selection of auditors in the hands of the independent directors.[37]

The Advisory Group also recommends that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives. Such meetings provide additional assurance that the Committee can candidly discuss with the auditors any questions they may have regarding accounting practices or internal controls. The Audit Committee also may want to meet separately with management, to learn its assessment of the auditors and the appropriateness of the audit fees.

The Advisory Group also recommends that the Audit Committee request an annual representation from the auditor of its independence from management. Many audit firms today also engage in management consulting and other functions, which may result in a non-audit relationship with the fund's manager or its affiliates. The Audit Committee should ask the auditor to describe all such relationships. If they exist, the Audit Committee should consider whether the relationships or the fees involved raise questions about the auditor's independence, and whether the auditor, in its evaluation of management's internal control structure, may be in the position of evaluating a control system recommended by the auditor's own consulting group.

The Advisory Group recommends that the Audit Committee have a written charter spelling out its duties and powers. A written charter helps ensure that both the Audit Committee and the full board understand the Committee's role, and contributes to the Committee's independence of action when difficult issues arise.[38]

---

[37] Indeed, the audit function is considered so important that the selection of auditors is one of the few functions that the Act consigns exclusively to the independent directors.

[38] Appendix F to this Report contains a sample of such a charter.

9. SEPARATE MEETINGS OF THE INDEPENDENT DIRECTORS

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

The Advisory Group believes that separate meetings of the independent directors, outside the presence of management representatives, can enhance independence and effectiveness. A separate meeting of the independent directors is especially important in connection with the annual review of the advisory and underwriting contracts required by the Act. Such meetings allow the independent directors to discuss the adviser's performance outside the presence of its personnel, consider what areas may call for improvement and critically analyze the reasonableness of the proposed contracts. A separate meeting also is especially important on such matters as a management proposal for a fee increase or other significant change in the terms of the arrangement between the fund and its affiliated service providers, or questions involving claims against the adviser or its affiliates.[39]

The Advisory Group believes that separate meetings of the independent directors can be beneficial in other circumstances as well. Accordingly, the Advisory Group recommends that the independent directors also meet separately on such other occasions as they consider appropriate. At these separate meetings, which can be held in conjunction with regularly scheduled board meetings, the independent board members can, for example, review upcoming agendas and determine what items, if any, should be emphasized when the full board meets or discuss other issues that warrant special attention or study during the year. Counsel to the independent directors or, if appropriate, counsel to the fund, also should attend these separate meetings.

---

[39] See Schuyt, 663 F. Supp. at 966.

10. LEAD INDEPENDENT DIRECTOR OR DIRECTORS

The Advisory Group recommends that independent directors designate one or more "lead" independent directors.

The Advisory Group believes that the effectiveness of independent directors is enhanced if one or more of them serves in the capacity of a "lead" independent director. A lead director can help to coordinate activities of the independent directors, such as by chairing separate meetings of the independent directors (see Recommendation 9 above) and by raising and discussing issues with counsel. A lead director also may act as a spokesperson for the independent directors in between meetings of the board. From fund management's perspective, it can be useful to have a point of contact among the independent directors with whom management can discuss ideas informally.

While many fund boards may find it optimal to have a single director act in the capacity of lead independent director, others may prefer to divide these responsibilities among two or more independent directors. For example, one independent director (e.g., the Chair of the Audit Committee) could act as the independent directors' spokesperson on matters related to financial reporting, while another could perform a similar role with respect to issues involving contracts with service providers. The Advisory Group also notes that in the case of smaller boards (e.g., with only three independent directors), there may be less need to designate one of them to act in this role. Finally, the Advisory Group wishes to emphasize that the designation of one or more persons as lead director should in no way imply that the obligations or commitment of the other directors are diminished.

11. INSURANCE COVERAGE AND INDEMNIFICATION

The Advisory Group recommends that fund boards obtain directors' and officers'/errors and omissions insurance coverage and/or indemnification

from the fund that is adequate to ensure the independence and effectiveness of independent directors.

The relationship between independent directors and fund management rarely results in litigation. There have been two recent cases, however, where fund management sought to resolve serious differences with the independent directors through litigation. Such instances have emphasized to the Advisory Group the importance of ensuring that independent directors be able to take whatever action they believe in good faith to be necessary for the protection of shareholders without concern over personal liability from litigation, particularly litigation with fund management. Such litigation can be extremely expensive and may even carry with it a potential for personal financial ruin. Consequently, the absence of adequate insurance coverage or indemnification can discourage independent directors from acting aggressively in the interests of fund shareholders and even discourage qualified individuals from serving as independent directors.

For these reasons, the Advisory Group recommends that independent directors obtain directors' and officers'/errors and omissions ("D&O/E&O") insurance coverage and/or indemnification from the fund that is adequate to ensure their independence and effectiveness. In determining whether such coverage is adequate, directors should consider a variety of factors. One factor to be considered is whether any such insurance policy would provide coverage in instances in which a fund's independent directors and its investment adviser are opposing parties in litigation. D&O/E&O policies generally have broad exclusions for suits between "co-insureds" and thus may not provide coverage in these circumstances.[40] Directors also may wish to consider whether their fund insurance policies and/or indemnification provisions in fund charters or bylaws

---

[40] Chairman Levitt recently suggested that independent directors check their insurance policies to make certain that their policies do not exclude suits between "co-insureds." See Remarks of SEC Chairman Arthur Levitt, supra note 4.

provide continuing coverage for claims arising in connection with their service as directors after the directors cease to serve on the board. Otherwise, directors could be deterred from acting independently out of concern that they would lose coverage after leaving the board for actions taken while serving as directors. Similar issues may arise if the policy is terminated or modified after directors leave the board. For this reason, directors may wish to ensure that they would have adequate coverage even if the policy subsequently is terminated or modified and to ascertain who would pay for such extended coverage.

12. UNITARY OR CLUSTER BOARDS

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

Most funds today are part of complexes comprising multiple funds managed by the same investment adviser. Boards of these funds generally are organized according to one of two models -- a "unitary" board consisting of one group of directors who serve on the board of every fund in the complex, or "cluster" boards consisting of two or more separate boards of directors for groups of funds within the complex. Clusters typically are organized according to investment objective, investment sector or distribution channel or result from a merger of complexes that were initially organized under separate management.

Questions have recently been raised whether service on more than one board within the same complex somehow compromises the independence of directors.[41] The Advisory Group has

---

[41] See Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997) (service on boards of multiple funds within a complex held to render directors not sufficiently independent under Maryland corporate law to evaluate a demand that fund sue management (continued)

found no evidence that this is the case, and sees no reason why it should be the case, especially where independent directors control the nominating process and set their own compensation.[42] Instead, the Advisory Group believes that service on multiple boards can provide the independent directors of those boards with an opportunity to obtain better familiarity with the many aspects of fund operations that are complex-wide in nature.[43] It also can give the independent directors greater access to the fund's adviser and greater influence with the adviser than they would have if there were a separate board for each fund in the complex. Moreover, it would be much more difficult to attract highly qualified directors if they were limited to service on the board of only one fund in a complex. There also would be additional costs, administrative complexities and redundancies. Some fund complexes would be forced to have scores of independent directors.

For these reasons, the Advisory Group recommends that all fund complexes with any substantial number of funds generally adopt either a unitary or a cluster board structure.[44] This should not preclude funds in a complex from having additional directors or separate boards where appropriate. For example, a country-specific fund may find it helpful to have a director or directors with special knowledge of that country. In general, however, the Advisory Group believes that fund complexes should not have a separate board for each fund in the complex.

---

company). Maryland and Massachusetts have since adopted legislation stating that investment company directors who are independent under the Act are considered independent under state law. To date, similar claims under the Act have been uniformly rejected by the courts. See, e.g., Strougo v. BEA Associates, 98 Civ. 3725 (S.D.N.Y. Mar. 11, 1999); T. Robert Verkouteren v. Blackrock Financial Management, Inc., 98 Civ. 4673 (S.D.N.Y. Feb. 4, 1999).

[42] SEC Chairman Levitt recently stated, "There have been questions raised in the press and in the courts about whether simply serving on multiple boards or portfolios compromises a director's independence. Recent court decisions say it doesn't. And I'm inclined to agree." Remarks of SEC Chairman Arthur Levitt, supra note 4.

[43] These aspects include, for example, the nature and quality of compliance, administrative, transfer agency and custodial services, as well as the distribution channels used by the complex.

[44] It should be noted that where funds are organized as series of a corporation or trust, all of such series necessarily have the same board of directors.

Because each has certain advantages, the Advisory Group believes that the choice between a unitary board and cluster boards is best left to individual fund organizations.

13. RETIREMENT POLICY

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

The Advisory Group recommends that investment company boards adopt policies governing retirement of directors. Boards should provide for administration of these policies by the independent directors or a committee of independent directors in order to prevent fund management from having control over their implementation.

In adopting a retirement policy, the board should consider whether setting a specific mandatory retirement age would enhance the board's effectiveness. In doing so, the board should balance the need for fresh perspectives against the benefits that the experience and institutional memory of existing directors can provide. Some boards of directors have opted to institute retirement policies that call for board members to step down upon reaching a designated age. As an alternative, boards may wish to consider setting specific term limits on the service of fund directors.

14. EVALUATION OF BOARD PERFORMANCE

The Advisory Group recommends that fund directors evaluate periodically the board's effectiveness.

Several of the recommendations set forth above suggest important steps that boards can take to improve their operating effectiveness. It also can be helpful, however, for boards to step back periodically and review their overall performance. The Advisory Group recommends that all

boards periodically conduct such an evaluation, which should focus on both substantive and procedural aspects of the board's operations. The evaluation need not be done in written form.

The Advisory Group does not believe it is feasible to list specific criteria against which a board should measure its effectiveness. Given the widely varying nature of different fund complexes, board composition and operating needs, it is impossible to specify criteria that would apply to all. Examples of issues that directors may want to consider during the course of their evaluation include:

(1) Whether the board meets with the right frequency.

(2) Whether the materials provided to the board are useful, sufficient, and properly focused. Boards also may want to consider whether materials are received far enough in advance of the meeting to allow for a thorough review.

(3) Whether the board focuses on the most important matters and whether an appropriate amount of meeting time is devoted to issues that the independent directors consider to be most important. The independent directors also may want to consider how the agenda is established, what matters must be covered by reason of regulatory requirements, and whether there is enough time reserved to discuss the issues they consider important.

(4) Whether there is sufficient opportunity for the independent directors to meet separately from management to consider agenda and other issues.

(5) Whether board members participate actively, ask pertinent questions and contribute meaningfully to the board's deliberations.

(6) Whether the board's ability to handle its workload efficiently and effectively would be enhanced by a different form of organization, such as use (or greater use) of committees.

(7) Whether the board has the right mix of backgrounds, skills and experience. Diversification of experience and professional backgrounds can contribute to the board's effectiveness.

(8) Whether the board understands and is in agreement with fund management's objectives and criteria for evaluating whether those objectives have been achieved. For example, the independent directors may want to ensure that they are made aware of, and are satisfied with, any benchmarks or other standards utilized by the fund's adviser in areas such as investment performance and shareholder services.

15. ORIENTATION AND EDUCATION

The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments.

In recognition of the detailed regulation to which investment companies are subject and the extensive duties imposed on fund directors, the Advisory Group believes it is important that new fund directors receive appropriate orientation. Such orientation can be conducted by fund management or fund counsel, for example at a special meeting. New directors, in particular, also

may find it helpful to attend conferences or educational seminars geared towards the work of investment company directors. The Advisory Group further recommends that all fund directors keep abreast of industry and regulatory developments. This can be done in many ways, including by regularly reviewing written materials that address industry and regulatory topics (such as reports prepared by fund counsel), by holding special sessions of the board that focus on particular topics or by attendance at conferences and educational seminars.